

# Financial Services Agency

Summary Points from

## Strategic Directions and Priorities 2016 - 2017

## The JFSA's second annual *Strategic Directions and Priorities*

- The Financial Services Agency (JFSA) published its first *Strategic Directions and Priorities* in September 2015, clarifying its policy goals for the program year 2015 (July 2015 to June 2016).
- After the completion of the program year 2015, the JFSA reviewed the progress made and identified the remaining tasks and emerging issues. It summarized the findings in the report published in September 2016: *Progress and Assessment of the Strategic Directions and Priorities 2015-2016*.
- Building on the findings, the JFSA has updated its business plan and issued its second annual *Strategic Directions and Priorities* in October 2016, marking the start of another round of the Plan-Do-Check-Act cycle for continuous enhancement of the quality of regulation and supervision. The following pages present the JFSA's key policy goals for the program year 2016.

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# I. Mission and priorities

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## ■ Mission

The JFSA's mission is to contribute to the national welfare by securing sustainable growth of national economy and wealth through achieving the following three sets of goals:

- i. Financial stability and effective financial intermediation;
- ii. Consumer protection and consumer benefit; and
- iii. Market integrity and market vigor.

## ■ Priorities for the program year 2016

To attain its mission, the JFSA will:

- i. Reform the agency and its approaches;
- ii. Transform the flow of funds and help the accumulation of the household assets; and
- iii. Support financial institutions change their business models and create shared value with their customers.

## II-1. New supervisory approaches

The FSA established the Advisory Group on Supervisory Approaches in August 2016 to explore new supervisory approaches.

### The past

- On-site inspection focusing on classification of individual loans contributed to ending the financial crisis in 1990s and early 2000s.
- On-site inspection focusing on compliance and the identification of misconducts enhanced customer protection and market integrity.
- If mechanically applied repeatedly, however, the past *modus operandi* may create unintended consequences or fail to address emerging issues.

### The future

- ✓ From ***Form*** to ***Substance***  
Dialogue on business models, better risk management and innovation added to compliance check.
- ✓ From ***Backward-*** to ***Forward-looking***  
Sustainability of business models and adaptiveness to changing environment to be discussed in addition to past balance-sheet numbers.
- ✓ From ***Individual elements*** to ***Holistic view***  
Devote supervisory resources to address underlying root causes, rather than focusing on specific incidents; and to identify overall risk profile, rather than focusing on individual loan classification.

## II-2. Unleashing the market mechanism

### **Supporting market mechanism and promoting competition to improve quality of financial services**

- The JFSA will promote competition in the financial sector to better serve the interests of customers by eliminating information asymmetry between financial institutions and their customers through the following measures:
  - ✓ Enhancing disclosure on commissions and fees for financial products and services
  - ✓ Encouraging financial institutions to voluntarily disclose their business practices to meet customers' needs
  - ✓ Communicating findings the JFSA recognized through its supervision to the public
  - ✓ Establishing an award system for excellent practices of financial institutions

## II-3. Governance, dialogue with stakeholders, HRM

### **Towards an open and innovative agency which continuously reforms itself**

- To adapt to changing environments, the JFSA will:
  - Change the decision-making process so that it can reflect suggestions and criticisms from outsiders;
  - Share the JFSA's perspectives and hold dialogue with various stakeholders/parties including financial institutions, corporations and households; and
  - Adopt HRM policies to motivate its members of the staff to take initiative in contributing to the national welfare by:
    - ✓ Amending performance evaluation criteria
    - ✓ Developing training program to help the staff acquire cutting-edge expertise
    - ✓ Creating working environment which would facilitate work-life balance and innovative thinking

# III-1. Transforming the flow of funds: Households

## Realizing the benefit of long-term, regular and diversified investment

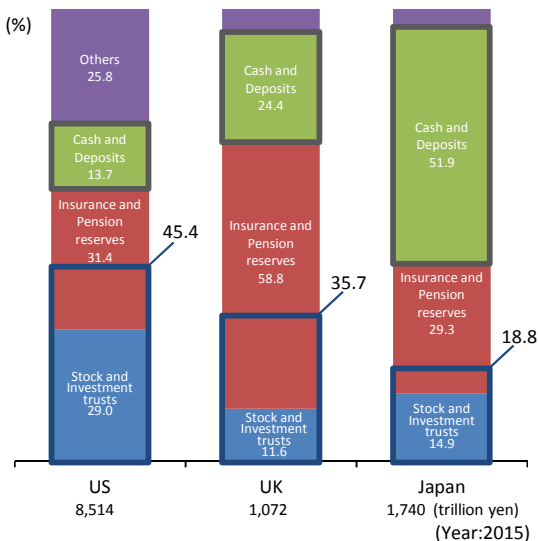
Issues to be addressed:

- Majority of the household financial assets are held in cash and deposits
- Poor investment performance
- Lack of the experience of investment success as well as financial literacy

The JFSA will:

- Work to improve the NISA (Nippon Individual Savings Account) tax benefit scheme to promote long-term, regular and diversified investment;
- Promote practical investment education for beginner investors; and
- Ensure that consumers can make a good comparison and a well-informed choice when purchasing investment trusts and other financial products.

Composition of financial assets held by household sector



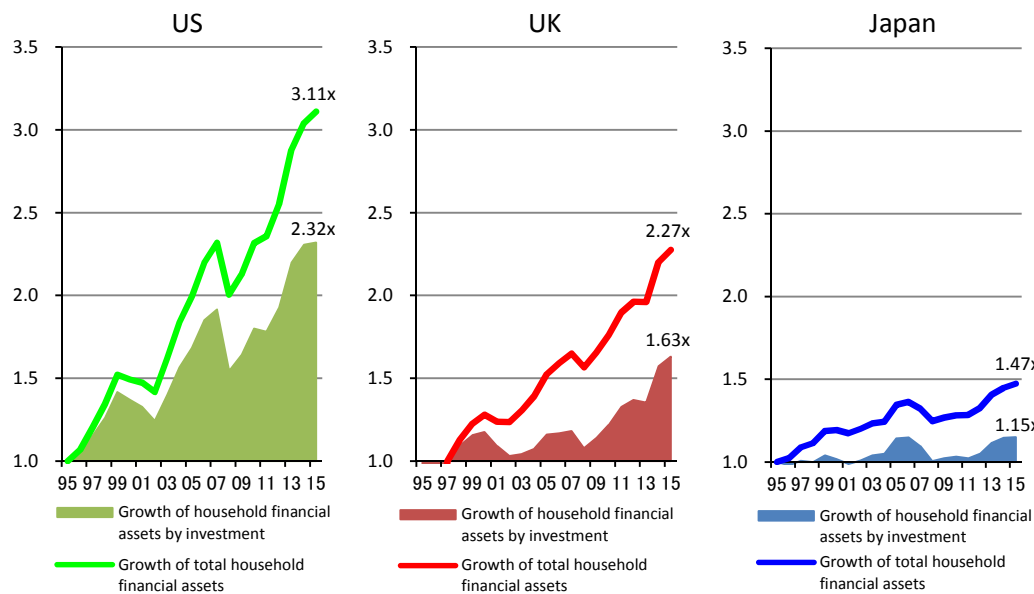
■ means share of stock and investment trusts including indirect investment via Insurance and Pension reserves.

Note: Exchange rates at the end of 2015.

(\$1 = 120.3JPY, £1 = 177.3JPY)

Source: FRB, BOE and BOJ

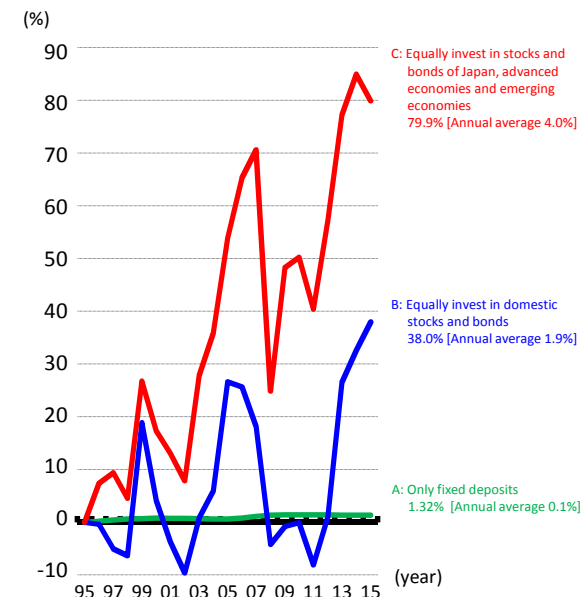
By saving or by capital gain?  
Growth of household financial assets



Note: Base years are 1995(US, Japan) and 1997(UK).

Source: FRB, BOE and BOJ

Effect of long-term and diversified investments



Source: Bloomberg



# III-2. Transforming the flow of funds: Financial institutions

## Customer-oriented asset management and intermediation

Issues to be addressed:

- Financial institutions tend to prioritize products with high commission fees.
- Consumers are not effectively communicated of the commission fees they pay and the risk of the financial products they purchase.

The JFSA will:

- Establish codes and principles for customer-oriented business conducts to ensure financial institutions fulfill their fiduciary duties in a broader sense of the term;
- Encourage enhanced disclosure on commission fees and improved explanatory materials on the risks of financial products; and
- Promote voluntary disclosure by financial institutions on their policy on customer-oriented business conducts.

Five largest investment trusts in US and Japan: differences in size, efficiency and performance

	Average asset size (trillion yen)	Sales fee	Trust fee	Rate of return
		Average		Average of the past 10 years
Japan	1.1	3.20%	1.53%	-0.11%
US	22.6	0.59%	0.28%	5.20%

Note1: The asset size of US is converted at USD/JPY = 112.43.

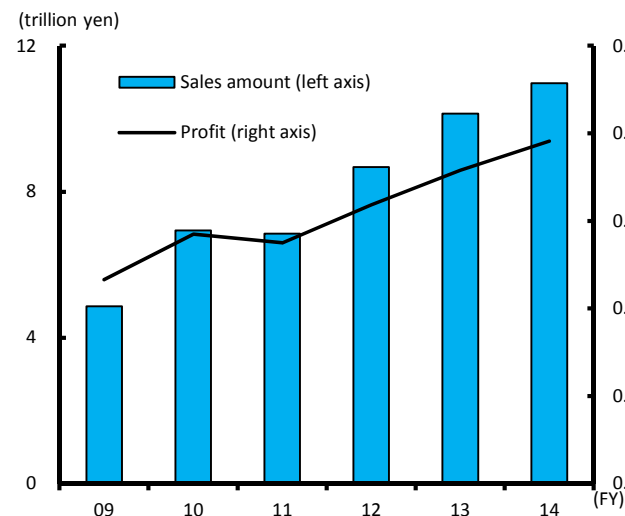
Note2: The sales fee in Japan is at the upper end of fees.

The sales fee in US is a weighted average based on the amount in each share class.

Note3: The rate of return is calculated subtracting sales fee, and assuming that the dividend is not reinvested.

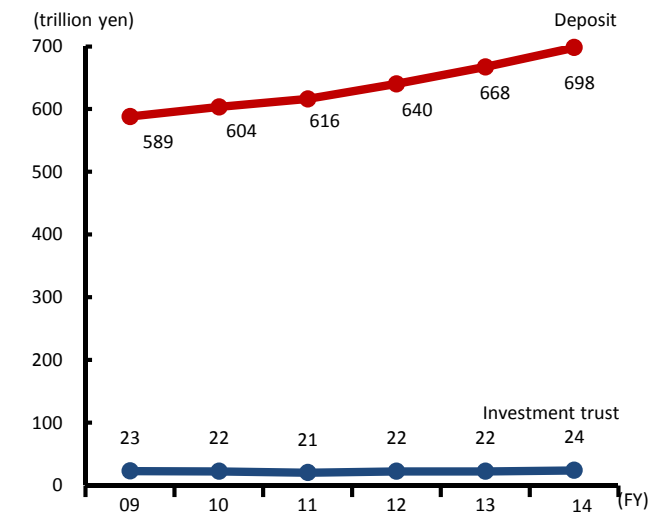
Source: QUICK and published data from US asset management firms

More investment trusts sold every year...



Note: Sum of major banks and regional banks  
Source: JFSA

... but, despite the growth of bank deposit, the stock of investment trust does not grow.



Note: Sum of major banks and regional banks  
Source: Japanese Bankers Association and JFSA

## III-3. Transforming the flow of funds: Institutional investors

### Enhancing corporate value through engagements

Issues to be addressed:

#### ■ Rooms to enhance

- ✓ Asset management skills and strategies
- ✓ Long-term investment based on the assessment of the values of individual companies
- ✓ Constructive engagements with investee companies

The JFSA will:

- Amend its Stewardship Code to encourage institutional investors (asset owners and asset managers) to constructively engage with the companies they invest in the best interest of ultimate beneficiaries;
- Ensure asset managers to serve the best interest of customers by strengthening governance and management over conflicts of interests arising from their relationship with affiliate companies; and
- Promote engagement of asset owners (such as pension funds) with asset managers for enhanced stewardship activities.

## III-4. Transforming the flow of funds: Market surveillance and disclosure

### **Market surveillance to address more globalized, complex and sophisticated financial transactions**

- The Securities and Exchange Surveillance Commission will conduct flexible and timely market surveillance based on market analysis with a macroeconomic perspective.

### **Improving the quality of audit, disclosure and accounting standards**

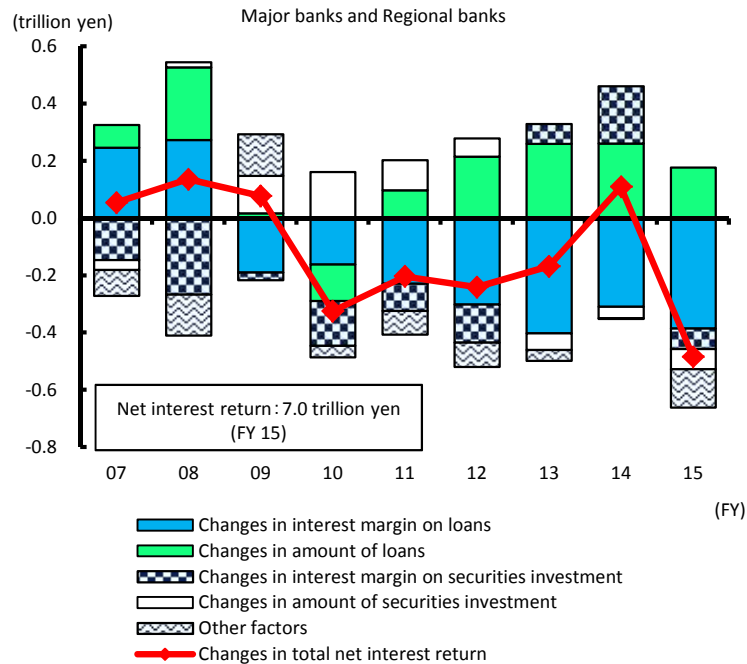
The JFSA will:

- Develop the Audit Firm Governance Code to improve the quality of auditing; and
- Establish a task force to discuss the introduction of a fair disclosure rule to ensure fairness and transparency in disclosure. The rule will require listed companies to provide nonpublic information to all other investors simultaneously when the information is provided to a third party.

## IV. Towards creating shared value

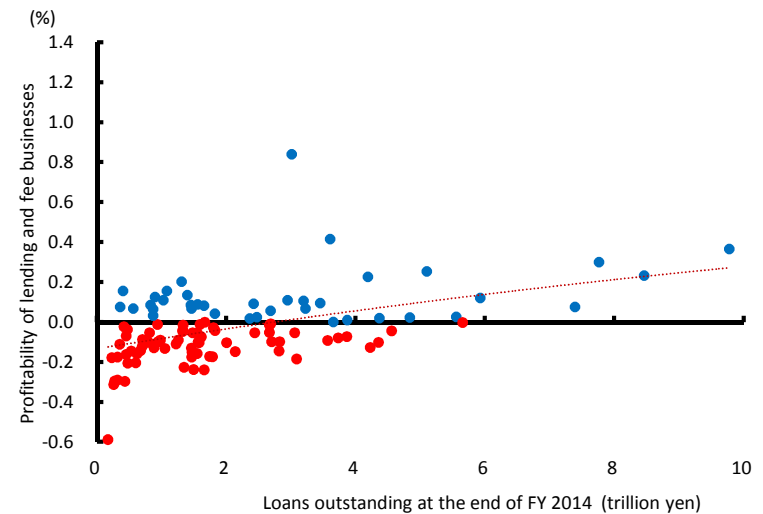
- Dramatic changes in the environment financial institutions operate in – such as globally persistent low and flat yield curve and technological innovations – are rendering balance-sheet size oriented business models unsustainable. Each financial institution needs to review the sustainability of its current business model.
- Sustainability of business models may be enhanced by creating shared value with customers. If financial institutions provide high-quality financial services for the best interest of customers, that will help enhance the productivity of the corporate sector and contribute to steady asset accumulation of the household sector, and the resultant stronger customer base will secure a stable revenue flows.

Increased lending volume has failed to offset compressed loan margin.



Source: JFSA

It is estimated that more than 60% of regional banks will suffer from negative profitability in lending and fee businesses in 2025, due to factors such as shrinking working age population.

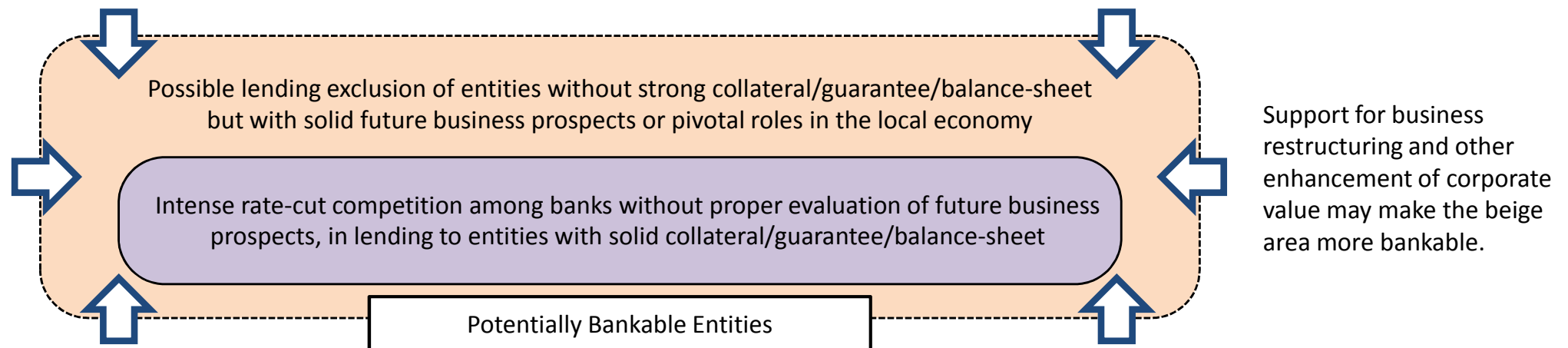


Source: JFSA

## IV-1. Monitoring lending exclusion

### Are there lost opportunities for banks, customers and local economy?

- A perception gap exists between financial institutions and their customers on banks' lending practices.
  - ✓ **Bank:** bankable customers are scarce, and thus competition by rate discount becomes fierce
  - ✓ **Customer:** Banks make no loan without collateral or guarantee
- The JFSA will closely monitor if lending exclusion, or unavailability of lending to companies with solid future business prospects, is observed in the Japanese market.



## IV-2. Dialogue with banks utilizing a new set of indicators Enhanced disclosure to promote competition

### **In-depth dialogue with financial institutions**

- The JFSA will conduct in-depth dialogue with senior management of financial institutions over effective financial intermediation through discussion on governance, performance goals and evaluation, and loan screening systems, with the help of the newly introduced set of benchmark indicators on banks' financial intermediation\* and of findings from monitoring of their initiatives.

\* Note: The set of 55 benchmark indicators has been introduced in September 2016. They indicate how banks implement their policy to meet their customers' needs. The indicators include: the number of clients whose business performance has improved, the number of start-ups the bank supported, and the number of lending made based on the borrowers' future business prospects.

### **Enhanced disclosure to promote competition for better financial services**

- The JFSA will encourage financial institutions to voluntarily disclose their efforts to meet customers' needs and give awards for excellent practices in order to promote active competition among financial institutions in providing high-quality financial services.

## IV-3. Forward-looking prudential supervision

### Maintaining soundness of the financial system

- In light of the rise in asset prices worldwide, the JFSA will hold dialogue with financial institutions based on the analysis of various stress scenarios and their impacts, in order to sustain soundness of Japan's financial system and to maintain effective financial intermediation even in cases of domestic or global economic downturn and/or market turbulence.

#### **On overseas operations:**

- ✓ The JFSA will hold dialogue to ensure flexible and timely management of overseas credit exposure risks and to secure more stable foreign currency funding, in response to rapidly changing economic conditions and market environments.

#### **On domestic operations:**

- ✓ In the face of declining domestic interest rates, banks are increasing investments in longer-term bonds and credit exposures to the real estate sector. The JFSA will assess the effects of such risk-taking on their financial soundness as economic conditions and market environments fluctuate, and will hold dialogue with them accordingly.
- ✓ The JFSA will encourage banks to address the problem of business model sustainability if it is judged to pose a serious risk.

## V-1. FinTech, cyber-security and algorithmic trading

### FinTech

- FinTech (integration of finance and IT technology) is expected to bring about enormous change to the financial industry.
- So as to allow FinTech innovation to contribute to the provision of better financial services, the JFSA will review legal frameworks in a timely manner, upgrade the payment and settlement infrastructure, and facilitate the use of new financial technologies.
- Financial institutions will need to make a proactive decision for innovation, including changes in their organization, human resources and IT system, and the JFSA will support their timely actions.
- The JFSA will continue to create a favorable environment (ecosystem) for advent and growth of FinTech start-ups.

### Cyber security

- Cyber-attacks have become one of the greatest threats to the financial system.
- The JFSA will conduct its first industry-wide exercise to upgrade capability against cyber-attacks of the financial industry.

### Algorithmic trading

- The JFSA will consider appropriate regulatory options to deal with algorithmic trading in Japan, while monitoring progress in other jurisdictions.



## V-2. Global regulatory reforms, building global network

### **Proposing future directions for the global regulatory reforms**

- The JFSA has advocated that the global regulatory reform efforts should aim to attain both growth and stability. The JFSA will ensure that the remaining elements of the post-crisis reform be finalized in line with the principle. It will contribute to the global efforts to assess cumulative impacts of the reforms.
- Sustainability of business models is becoming a key factor in financial stability both in Japan and abroad, as yield curves become flat and low and technological innovation advances. The JFSA intends to develop new supervisory approaches to address the development and share its thinking with the global community.

### **Active contribution to improve global standards of audit through the IFIAR**

- The JFSA fully supports the IFIAR (International Forum of Independent Audit Regulators) in establishing its permanent secretariat, holding the plenary meeting in Tokyo in April 2017, and ensuring its smooth operation thereafter.

### **Global network and cross-border cooperation**

- The JFSA will continue to strengthen its global network and bilateral/multilateral relationships with regulatory authorities worldwide. It invites financial regulators and supervisors from emerging economies as trainees to the Global Financial Partnership Center (GLOPAC).